FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

February 2017

A guide to the FMA's view of conduct

This guidance note is for:

directors and executives of licensed financial services providers.

It gives guidance on what we will focus on when examining how licensed financial services providers demonstrate good conduct, and how they have met their governance and management responsibilities.

About FMA guidance

Our guidance:

- explains when and how we will exercise specific powers under legislation
- explains how we interpret the law
- describes the principles underlying our approach
- gives practical examples about how to meet obligations.

Guidance notes: provide guidance on a topic or topic theme. Typically we will seek industry feedback via a public consultation paper, or more targeted consultation before we release a guidance note.

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

You might also like to check the reports and papers on our website. For example, our monitoring reports describe actual practice we are seeing and our comments on this.

Document history

This version was issued in February 2017.

www.fma.govt.nz

AUCKLAND OFFICE | Level 5, Ernst & Young Building | 2 Takutai Square, Britomart | PO Box 106 672 | Auckland 1143
WELLINGTON OFFICE | Level 2 | 1 Grey Street | PO Box 1179 | Wellington 6140

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Overview

Why conduct matters

The conduct of those who provide financial services directly affects the consumers of those services, which is all New Zealanders. High standards of conduct support fair, efficient and transparent markets – and the confident participation in those markets of businesses, investors and consumers. This benefits our economy and all New Zealanders. Poor conduct, however, can destroy confidence and discourage participation in our financial markets.

Conduct is at the core of the Financial Markets Conduct Act (FMC Act). The FMC Act sets new standards for conduct, and adds weight to the FMA's existing statutory mandate to monitor conduct, and compliance with financial markets legislation, in New Zealand's financial markets.

The FMA will take a risk-based approach to this job. We will assess which financial service providers (providers), and what conduct, are mostly likely to pose risks to fair, efficient and transparent markets – and harm to investors and consumers – and direct our regulatory attention and effort accordingly.

As we try to assess risk, our focus will be on whether providers we regulate have the interests of their customers at heart. In particular, how that customer-centric perspective is embedded within how they go about approaching their compliance obligations and their business activities more generally.

The weight we place on conduct when calibrating our regulatory approach is a shift of emphasis for us. It is also a shift for those we regulate. They may need to think differently about what they do with their people and organisational culture, and their processes and controls, to show their customers – and, where necessary, us as regulator – that they understand what good conduct is, and can habitually demonstrate it.

Conduct is particular to each business or person and to their circumstances. A regulator cannot, and should not, prescribe how that happens. We appreciate that some people have already thought deeply about this. Others are still coming to grips with it. We expect this document to prompt those we regulate to examine how they think about good conduct to ensure they consistently deliver good outcomes to their customers.

What we want to achieve

This guide does not create, replace, or even supplement, existing legal obligations. Instead, it signals how we will use conduct as a 'lens' for looking at how providers behave when meeting their existing obligations to their customers, and for shaping how we interact with them. Our main focus will be ensuring that providers:

- understand what good outcomes are for their customers
- can demonstrate how boards and senior management communicate to the business an expectation that these outcomes are delivered, and how they are assured that this is done
- can clearly articulate, and support with examples – potentially including those arising from direct customer feedback or related channels such as mystery shopping or net promoter scores – how their conduct appropriately serves – and balances – customer, business and, where relevant, shareholder interests
- disclose to investors and the public what they are doing to meet their regulatory obligations and the principles of good conduct – for example by reference to the 'Good conduct profile' on page 8 – and how they are doing it.

How we will achieve it

To help providers understand our perspective, we will help them to assess:

- their capabilities, and to communicate how they can help their customers
- why the fees and costs of their products and services are reasonable, and to communicate this
- their business structure, strategy, services and products, and to communicate how their desired outcomes are aligned to good customer outcomes
- their governance and culture, and to communicate how their conduct demonstrates high standards of governance and culture
- their systems and controls, and to communicate how they support, as a minimum, a culture of compliance with regulatory obligations, and also meet the principles of good conduct
- the potential for misconduct, including market misconduct, and to communicate how they will identify, evaluate and address these risks.

This guide should not be seen as a checklist or manual. It is principles-based guidance about how we view conduct. It underpins how we think about licensing (and re-licensing), supervision, monitoring, and enforcement. It affects, for example, how we consider customer complaints and view customer outcomes. We have included questions to indicate what we will be looking for and asking about.

We hope providers find this guide useful when considering what they do and how they do it — particularly directors and senior managers who are not yet fully confident they can demonstrate good conduct.

Why we talk about customers

We think of a customer as an individual who buys financial products or services, including investment products. Providers of these products and services need to be aware of, and responsive to, their customers and their customers' financial capability, and tailor their conduct accordingly. We emphasise this because financial judgments and investment decisions are typically complex. Customer knowledge of financial markets and products – even of their own savings and investment goals – varies widely. Providers should be particularly sensitive to this and be able to show how they have taken steps to minimise the risk of misunderstandings and poor customer outcomes.

Customers have a responsibility to act in their own interest and make good decisions. But our perspective is that providers should think about how their conduct supports customers with the necessary information and understanding to exercise that responsibility properly. We note that the level of knowledge of, and obligations owed to, wholesale customers may be different to retail customers. All customers, however, are entitled to expect good conduct from their providers.

Who should read this guide

This guide is aimed at the directors and senior managers of providers licensed or authorised by us under the FMC Act or any other financial markets legislation (including the Financial Advisers Act). It is relevant to the work of our fellow frontline regulators: the NZX, auditors, trustees and supervisors. Additionally, because conduct is at the heart of all customers' experiences of financial products and services, it will also be relevant to other leaders and managers in the financial services industry.

Other FMA publications relevant to this guide

- Strategic Risk Outlook: our strategic priorities, including our focus on conduct, for the medium term
- Investor Capability Strategy 2015-2018: how we want to improve investor understanding and confidence
- Corporate governance in New Zealand: Principles and guidelines (December 2014).

Our website has further detail on some of the subjects discussed in this guide, which in some cases is intended for specific types of businesses or professionals. For example:

- Information sheet: Market misconduct risks — a guide for MIS managers (August 2015)
- Guidance note: Governance under Part 4 of the FMC Act (September 2014)
- Guidance note: Monitoring investment risk in KiwiSaver schemes (March 2014).

Conduct

Why good conduct matters

Good conduct matters because at its most basic level, conduct is how people behave. Standards, systems, processes and controls are all necessary, but they are predictable and can be exploited by behaviour.

Conduct is what the customer actually experiences.

Customers must be confident that their interests are being properly considered; that they are getting the right financial products and services at reasonable cost; and that they understand them. When this is the typical customer experience, it not only creates investor and public confidence in the fairness and transparency of specific businesses, but in the market in general. Good conduct ultimately creates more depth in financial markets and resilience when markets experience shocks or turbulence. Good conduct is good business.

What is good conduct?

At its core, good conduct means focusing on customers. The result is good customer outcomes. 'Good' does not mean that customers are insulated from risk or that a product always makes money (not least, because a 'positive' result is not necessarily the result of good conduct). Rather, it's where the outcome is within a range appropriate to the product and understood by the customer. Consistently good outcomes require sound systems and controls, being disciplined about meeting compliance obligations, and good disclosure. Most importantly, it needs to be part of an organisation's culture, including setting clear expectations and, crucially, leading by example.

Crucial because, in all workplaces, people look to examples set by their colleagues, and especially their leaders, to sense whether formal conduct expectations are real, or just rhetoric. They also observe whether there are clear consequences, including for the leadership, if those expectations are not met.

In other words, conduct is what actually happens regardless of systems, controls and formal rules.

We believe the following factors form a good conduct profile. We will use this when we address conduct issues.

- The provider has the skills and experience to competently provide an appropriate service or product to the customer, and can meet professional standards of care.
- The cost of the provider's product or service is reasonable (and does not reduce the return or benefit customers get from it, to the point where the customer's need is not met).
- The customer's interests are served as well as the provider's business interests, and any arrangements with related parties are transparent.
- The provider's culture encourages and recognises good conduct, from the leadership down, and customers can therefore be confident the provider will consistently act in the customer's interest.
- The provider will act with integrity, fulfil their responsibilities and obligations, and act honestly and fairly[1].

[1] For directors, this is deliberately consistent with the requirements of the Institute of Directors' *Code of Practice for Directors*

- The provider's checks and balances support good conduct, and identify and address poor conduct (including complaints and disputes resolution).
- The provider can convincingly demonstrate all of this in a clear, concise and compelling way. Internally (for example in a code of conduct), and externally.

Good conduct profile

Our view of good conduct behaviour

Providers might usefully regard the following factors as the building blocks for the FMA's view of the principles of good conduct. They are certainly the basis of the questions we have included in the 'Good conduct in practice' section of this guide, and will be used by FMA staff when dealing with conduct issues.

Capability

What the customer cares about: The provider has the skills and experience to competently provide a suitable service or product, and can meet professional standards of care.

Our focus:

- The purpose, benefits and risks of the services and products, and their suitability to different types of customers, are understood within the business and are clear to customers.
- We will look at the professionalism, skills and experience of the provider and how it continually improves its skills through training.
- It should be clear how performance is measured, and over what period. The provider should be able to explain the benchmark they have chosen: why it is appropriate, and how it is aligned with the stated investment philosophy and objectives. It should also be clear why the provider believes its performance is 'a good story' for customers.

Conflict

What the customer cares about: Their interests are served, as well as the provider's business interests, and any arrangements with related parties are transparent.

Our focus:

- The provider should clearly identify, manage and disclose its actual and potential conflicts, particularly how staff are incentivised. It should be able to explain why it believes its approach to incentives is aligned to customer interests. This includes what services and products are recommended to customers, and how any staff performance benefits are disclosed to and discussed with the customer.
- The provider should clearly explain any arrangement with related parties, which are relevant to the customer.

Culture

What the customer cares about: The provider acts in the customer's interest, treats them honestly and fairly, and fulfils its duties and obligations.

Our focus:

- It should be clear what behaviour is expected from everyone at the provider (including its leaders).
- More importantly, we want to see examples of how staff (including leaders) make conduct expectations clear and that any breaches are identified and appropriately acted upon (and good conduct is recognised).

Control

What the customer cares about: The provider has checks and balances in place to support good conduct and to identify and address poor conduct, including complaints and disputes resolution.

Our focus:

- Leaders should be able to show – potentially including direct feedback or other insights from customers – how they know good conduct is occurring.
- The provider should be able to demonstrate a transparent and effective complaints and disputes resolution process, and show that lessons learned are integrated into business practices.

Communication

What the customer cares about: The provider listens to what they want, and the customer can easily understand its services or products.

Our focus:

- It should be clear to customers what they are paying in fees and expenses. Providers can explain how these are calculated, and why they believe the cost and calculation method are reasonable for the relevant product or service.
- The provider should communicate proactively, often and in plain language with customers, especially if something goes wrong.
- The provider should have clear and effective lines of communication between boards, senior management, and frontline staff, to ensure a focus on customer outcomes at all levels of the business.

What this means for boards and senior management

The FMA does not prescribe culture. Boards and senior leaders determine culture, and are accountable for it. This means they are accountable for what actually happens at their organisation, and for how customers are treated overall.

A good culture encourages all staff to look out for, and look after, customers. It values customers, and gives customers products and services which are appropriate to their needs and which they understand. It means that across an organisation, from the leadership down, there is a common understanding of desired business outcomes and how they align with customer objectives and outcomes.

If a business achieves this, it is far easier for:

- legal advisers to clearly understand what the provider is trying to do, and how, and for their vetting to occur in that context
- staff to see that business and customer outcomes are closely related, and that what they do directly influences both outcomes
- leaders to demonstrate to us, customers and stakeholders that what they do and how they do it meets compliance obligations and good conduct principles.

Good conduct in practice

This section is designed to help providers understand our view of conduct in more detail. The questions below reflect topics our staff may cover when monitoring and engaging with those we regulate. We have included a glossary of terms commonly used in the context of conduct, which we believe may be useful for readers.

While we hope this additional detail is helpful, like the rest of the guide it should not be seen as a checklist or manual. Providers are accountable for ensuring that their governance structures, control mechanisms and organisational culture are sufficiently relevant, suitable and sustainable to support good organisational conduct. If further guidance or help is required, we strongly encourage providers to seek independent advice from a trusted professional adviser, including, if appropriate, their supervisor.

Capability

- How do you know your products and services can meet, and are meeting, your customers' needs?
- How do you know you are good at knowing your customers, including their level of financial sophistication?
- Do you help the least-sophisticated customers to identify their needs? How?
- If a customer's needs require, or include, a product or service you do not offer, do you make this clear?
- How do you know that the performance (the return or benefit) of your products and services is consistent with good outcomes for customers? In particular, that the return or benefit is appropriate compensation for the risk being faced by the customer?
- How do you encourage customers to understand the pros and cons of your products and services relative to similar services and products offered elsewhere (or which the customer already uses)? Or, how do you confirm that customers have already done the appropriate due diligence prior to selecting a service or product from you? And how do you communicate all of that?
- How do you ensure you have effectively identified and addressed any capability gaps? How do you ensure you have the right capability before implementing growth strategies?
- How do you benchmark your capabilities? What standards do you use and why are they appropriate?
- What do you do after a sale – e.g. analytics, oversight – which helps you to answer the above questions?

Conflict

- How do you demonstrate that your customer needs and business strategies are aligned?
- How do you demonstrate that the way leaders and staff are paid supports focus on good customer outcomes?
- How do you know whether your cross-selling strategies, and practices, are appropriate?
- How do you demonstrate that rapid growth is not due to a misalignment of customer need and business strategy – for example, unreasonable pricing; inappropriate communication or market approaches; or inappropriate customer or staff incentives?

Culture

- How do you ensure your staff understand the degrees of alignment between your business and customer outcomes, and their direct participation in and impact on that relationship? How do you ensure they deliver this?
- How does the board and senior management signal to the business their expectations regarding improving customer outcomes? What reporting does the board receive to allow it to assess how these messages are received and acted upon?
- How do you evaluate and reward good conduct and appropriate behaviour within your organisation? How do you address poor conduct, and how could you demonstrate that?
- If problems arise, do you have the right structures, capabilities and courage to address them, including at the board level? How would you demonstrate that?
- How do you know that you have effective mechanisms in place for staff to raise concerns with people who are able to address them appropriately?
- How do you know you are good at challenging people, having difficult conversations, and providing constructive feedback to ensure accountability?
- How do you know you learn lessons from your mistakes and failings?
- How do you know that you stick to good conduct principles when under pressure?
- How do your recruitment, retention, training and development and remuneration and incentive frameworks help you to answer the above questions?

Controls

- How do you know that the culture you claim to have is actually followed in the business? Do you have, for example, robust customer satisfaction methodologies?
- How do you ensure your perspective on your customers remains relevant? Do you use, for example, mystery shopping, customer call-backs, or surveys?
- Given your size and complexity, and your customer base and stakeholders, do you have the right skills, expertise and experience to provide the necessary oversight, challenge and action? How do you demonstrate that you have considered whether you need more or stronger capabilities by adding new board members and/or outsourcing?
- Given your resources and the risks you manage, how do you assess your controls and prioritise compliance activities?
- If you outsource your operational functions, how do you ensure you have the right monitoring mechanisms and controls in place to ensure you understand what your outsource partner is doing and how they are doing it?
- Does your board regularly assess its own effectiveness, and whether its role and objectives remain suitable for your operating environment?
- Do you have sufficient knowledge of, and insight into, what management is doing, from sources other than management? How do you know that good conduct principles are being put into practice, and that the right people are being held to account?

- How are you satisfied that there is a clear separation of accountabilities and an appropriate division of responsibilities amongst management?
- How are you satisfied you have spent sufficient time deciding how much risk you need to take on and where your limits are set? And that your parameters are supported with appropriate controls, such as early warning indicators and hard-stop mechanisms? And that these are sufficiently proactive and frequent?
- Do you have an appropriate whistleblowing process, and how can you demonstrate its effectiveness?

Communication

- Is your disclosure to customers accurate, clear, concise, effective and timely? What about when things go wrong? How do you explain to your customers the range of expected outcomes of a particular product; and ensure they understand that? Is that quality consistent across all your communication channels, such as your website, advertisements, statements, and brochures? How do you know this?
- Do your customer processes support staff listening to customers' needs and preferences, and understanding how the business can meet them?
- How do you know that customers' needs are being understood by the business?
- How do you know whether your customer complaints management and feedback process is effective?
- Are your customers paying a reasonable price (including ongoing fees and charges) for your products and services, and how do you demonstrate to your customers – through disclosure and discussion – that the price and the way it is calculated is reasonable? If a fee or charge is payable in the future and the amount is not known at the time of the sale (e.g. with derivatives) have you clearly disclosed how that will be calculated?
- Is the information you have provided about the price of your products and services, sufficiently clear to enable your customers to easily compare your prices with similar products and services offered elsewhere?
- Are you transparent about the costs that will be passed on to customers from – or will become payable by customers to – associated parties, third-party suppliers, or outsourced providers as a result of purchasing a product or service you supply?

Glossary & useful concepts

Compliance assurance programme	Provides assurance by challenging and testing the effectiveness of controls, and the adequacy of governance and management information that ensures the business meets its regulatory obligations. Minimum standards for a compliance assurance programme are set out in the licensing guide for managed investment schemes. It must: • include in-depth (not just day-to-day) testing of processes and controls. This testing, and its design, should be done independently of those involved in day-to-day processes and oversight, or by an external organisation • be sufficiently resourced, and undertaken by people with sufficient skills and experience • be approved by the provider's oversight body • include regular updates on the provider's progress against the programme. These should be regularly provided to the oversight body, and significant findings should be promptly reported and acted on.
Conduct risk	The risk that conduct may contribute to poor outcomes for customers (meaning, an outcome which is outside of what the customer has been told to expect).
Control environment	The control environment defines what is, and is not, acceptable. Control environment factors include the integrity, ethical values and competence of the organisation's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organises and develops its people; and the attention and direction provided by the board of directors. It sets the tone of the organisation and is the foundation for all components of control.
Demonstrate	To show with evidence. This proves that you do what you say you do by 'walking the talk'.
Good conduct	Good conduct is about doing the right thing by stakeholders: customers, investors, shareholders, employees and the public.
Governing guides	These outline accountabilities, roles, responsibilities, and the frameworks for how the business is governed. They may include charters, terms of reference, mandates, delegations, policies, procedures, and frameworks.
Internal audit	Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. Internal auditing is a catalyst for improving an organisation's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as objective independent advice.

Key risk indicators	Indicators that are aligned to their risk profile and risk tolerance levels. Once breached, they have prescribed actions that must be undertaken, such as escalation to the board via a chief executive or risk committee. Early warning indicators are identified metrics and elements that could signal a potential issue or risk, and drive further investigation and analysis, such as an increase in customer complaints.
Material information	If it would affect an investor's decision-making then it is material and should be disclosed and explained. It should be explained in the context and understanding of the intended and perceived market.
Net promoter score	A tool used to gauge the loyalty of an organisation's customer relationships. It is calculated from responses to a single question: 'How likely is it that you would recommend our company/product/service to a friend or colleague?' Scoring is generally on a 0 to 10 scale. Scorers of 9 or 10 are called 'promoters', and scorers of 0 to 6 are labeled 'detractors'. Responses of 7 and 8 are labeled 'passives', and are not included in the score. The net promoter score is calculated by subtracting the percentage of customers who are detractors from the percentage of customers who are promoters.
Oversight functionality	An oversight body (or 'functionality') that considers the adequacy and effectiveness of governance and compliance.
Risk and control self-assessment and attestations	This is a technique developed in 1987 and used by organisations to assess the effectiveness of their risk management and control processes. Management usually attests on a quarterly, six-monthly or annual basis that they have effectively managed the risk and controls they are responsible for. Self-assessment and attestation form part of an organisation's compliance framework but cannot be solely relied on. They must be used alongside other types of assurance, such as independent monitoring and assurance.
Risk appetite	The level of risk an organisation is willing to accept as manageable.
Risk management	Coordinated activities and processes to identify, assess, manage, direct and control potential risk events or situations. Can also be called Enterprise Risk Management.
Risk tolerance	The level of risk an organisation is prepared to tolerate to achieve its objectives. These levels are generally quantitative, such as 'zero tolerance to mandate breaches' and '2% tolerance on data inputting errors'. They are driven by likelihood and consequence (or impact) factors.
Stakeholder	Any party that has an interest in or is impacted by an organisation. These parties can be internal or external to the organisation and include customers, investors, employees, suppliers and the public (via consequences).
Whistleblowing	The reporting of insider knowledge of illegal or inappropriate activities occurring in an organisation. Whistleblowers can be employees, suppliers, contractors, clients or individuals who are concerned about activities taking place in an organisation, either by witnessing the behaviour or being told about it. Employees who report 'serious wrongdoing' in their workplace can be protected under the Protected Disclosures Act.